

Landowner Considerations in Selling Development Rights or Donating Conservation Easements

Jesse J. Richardson, Jr. and L. Leon Geyer

Landowners must take into account many things when deciding whether to sell development rights or donate a conservation easement. The distinction between these two actions involves whether the landowner receives a payment or not. The document (a conservation easement) is the same. If the landowner accepts less than fair market value in payment for the development, the transaction can be part sale of development rights and part donation of a conservation easement. Transferring development rights results in significant and usually permanent consequences. A landowner should not enter into an easement lightly without guidance from professional advisors or considering the impact on his/her heirs.

This article is not intended as a substitute for legal or accounting advice. It is intended to provide information on some of the pros and cons of selling or donating conservation easements. The landowner should consult an independent attorney and accountant for guidance through the increasingly complex considerations of whether a conservation easement is right for his/her family. Most of the considerations apply equally to working and non-working lands. However, we assume that the landowner is placing the easement on working agricultural or forestal lands.

A landowner should consider seven-generation sustainability when he/she is considering whether to sell or donate a conservation easement. Seven-generation sustainability is

the tenet that all decisions should be made with consideration for the effect they will have on the next seven generations to follow. Development of this concept is attributed to a precept of the Great Law of the Haudenosaunee (Six Nations Iroquois Confederacy), which requires that chiefs consider the impact of their decisions on the seventh generation.

What Is A Conservation Easement?

A conservation easement is a legal agreement that a property owner makes to limit the type and amount of development on his/her property. An easement may be perpetual or of limited duration (a "term easement"). Most conservation easements are perpetual term since the tax laws require a perpetual term to qualify for the tax benefits of a donation. In addition, most land trusts will only accept easements with a perpetual term. Perpetual easements bind all future owners of the property. While considerable debate exists as to the merits of perpetual versus term easements, that debate lies beyond the scope of this article. Our discussion centers on perpetual conservation easements.

The terms of an easement are negotiated between the landowner and the organization that will hold the easement, resulting in unique provisions in each easement. Except for rights explicitly given up in the easement document, the landowner continues to own, use, and control the land and can still decide who has access to the property and for what purpose. Except for historic preservation easements, public access is generally not granted. Even with historic easements, public access remains very limited.

Acknowledgment

The authors acknowledge the vast knowledge gleaned from discussions on these issues with Jan Geyer, Ed Overton, Ted Feitshans and Andrew Branan. The ideas generated from these discussions greatly improved this article.

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Sell or Donate A Conservation Easement

The decision whether to donate or sell a conservation easement involves consideration of a myriad of both positive and negative factors. An easement prevents development on a particular parcel and protects conservation values on that property. Federal and state tax laws apply **ONLY** to donations of easements, not to easements that are sold, an important consideration to keep in mind.

Effect on Property Value

In some circumstances, a conservation easement will not significantly reduce the value of the property or not reduce the value at all. Of course, in those circumstances, tax benefits will also be limited. On the other hand, the easement may severely reduce the value of the property. But with this severe reduction in value come increased tax benefits.

Federal Income Tax Deductions

The gift of a conservation easement that meets the requirements of the Internal Revenue Code is considered a charitable contribution, and the value of the easement can be deducted, within certain limits, from the donor's income. A qualified appraiser will calculate the value of the easement by assessing the market value of the donor's land before the easement is given, then subtracting the value of the land after the easement is donated.

For 2007, the charitable contribution limit for conservation easement donations is increased from 30 percent to 50 percent of adjusted gross income for the year. Any unused deduction for contributions in 2007 can be carried forward over 15 additional years, up from 5 years. At the end of the 15 years, the deduction is lost. Farmers who receive more than 50 percent of their income from agricultural activities can deduct up to 100 percent of their adjusted gross income for easements donated in 2007.

Virginia State Income Tax Credit

After January 1, 2007, when a Virginia landowner donates a conservation easement, he/she is eligible to receive a Virginia income tax credit of 40 percent of the value of the easement, in addition to other tax benefits. The landowner may use the credit to offset taxes owed. If the credit is not fully used up in the year of the easement donation, it may be carried forward for an additional 10 years. Furthermore, unused portions of the credit may be sold or transferred to other Virginia taxpayers.

A statewide tax credit cap of \$100 million per year applies to donations in 2007. In other words, in 2007, only taxpayers who register the first \$100 million in tax credits will receive the credits that year. This cap will be adjusted for inflation in 2008 and thereafter. Excess tax credit applications will be carried over to the following year. In addition, a 2 percent fee on sale of tax credits applies in 2007 and beyond. Finally, any donations resulting in a tax credit claim of \$1 million or more must be verified by the Virginia Department of Conservation and Recreation (DCR). DCR has set up guidelines by which these easements are verified. Easements resulting in a tax credit of less than \$1 million require no state review.

Estate Tax Benefits

An easement may lower the value of the landowner's taxable estate in two ways: (1) the easement reduces the value of the property, resulting in lower estate taxes; and (2) under the American Farm and Ranch Protection Act, if a landowner donates an easement, heirs can exclude up to 40 percent of the remaining value of the land from the estate taxes owed, based on a complex formula.

Note that the estate tax exemption for each person is \$2 million in 2007, increasing to \$3.5 million in 2009. The estate tax will be eliminated in 2010, but will return in 2011 with a \$1 million exemption. In other words, considerable uncertainty exists as to the future of the estate tax and, thus, estate tax benefits from a conservation easement donation.

Real Property Tax Benefits

In Virginia counties where use value taxation is in place (for details see *Horizons* 18:1, "Use Value Taxation in Virginia, A Brief Description), land subject to a conservation easement is usually entitled to taxation at use value rates applying to open space. Open space values usually considerably exceed agricultural use values but are below the highest and best use values generally used for real property taxation purposes. Valuations vary from locality to locality.

Effects on Landowner

A conservation easement insures that the particular parcel will not be developed in the future beyond what is allowed in the easement. Many landowners derive great pleasure in knowing that their land will remain undeveloped in perpetuity. This element of control proves to be important in many cases. Donors or sellers often cite control in perpetuity as a major reason for the decision. On the other hand, those not donating or selling often explain that they want their children or grandchildren to make those decisions.

Even if the value of the land remains relatively unchanged, easements restrict the flexibility of present and future owners. Conservation easements generally prohibit or severely limit subdivision of the property; for example, the landowner may no longer sell off one or two lots to pay catastrophic medical bills or the college education of a family member. Either all of the land is sold or none.

The subdivision restriction also makes division of the property among the children or heirs problematic. The land can be owned by a number of children or grandchildren. However, the limitations on houses and lots restrict the number of families that can occupy the property. Even if the easement allows house lots for the present children, future generations will be prohibited from dividing the property among all the heirs. Therefore, sale or donation of development rights may force some difficult decisions.

Regardless of the magnitude of the reduction in value, the easement may severely restrict the ability to borrow against the property. Lenders are generally leery of the impact of conservation easement restrictions on property values and, hence, do not readily accept the property as collateral.

While an easement ensures that the land will not be developed, it does not ensure that agriculture or forestry will continue on the property in the future. If economic conditions change or the future owner decides not to continue to keep the land in agriculture or forestry, the original purpose of the easement may be frustrated.

In addition, the easement may limit use of the property for agritourism activities, as well as alternative enterprises such as a bed and breakfast or hunt club. The terms of the easement should be carefully examined to determine allowable future uses. Complicating this evaluation is the fact that no one can accurately forecast what agriculture will look like 50 or 100 years into the future. Easements must be drafted to stand the test of time.

Future Generations' Concepts of Ownership

Most landowners who donate conservation easements feel compelled by a strong emotional tie to the land. In an ideal situation, future heirs will share this emotional tie and will appreciate the easement. However, children, grandchildren, and other heirs may not feel such strong ties to the land. These heirs may resent the restrictions on development. That the tax benefits accrue only to the donor and are temporary may exacerbate these feelings when the restrictions are perpetual.

If a landowner passes the property to a number of heirs, the co-ownership may raise issues in the future. If several families own the land, but only one may occupy the property, the land may have to be sold, removing the family farm from family ownership.

To avoid future issues of this nature, tough decisions must be made each time the property passes to the next generation. Does the landowner and his/her heirs have a plan to help prevent future disputes?

Asymmetry between Compensation and Restrictions

Donors should carefully determine the use of the tax benefits. The easement restricts the property forever. Will the financial benefits be invested to provide a perpetual nest egg? Or will the financial benefits expire quickly while the easement continues?

We hear accounts of landowners donating or selling development rights because they need the money. Financial need is the worst reason for donating or selling an easement. A financial plan should be developed with the assistance of a financial planner to ensure that future generations benefit from the donation or sale. If, on the other hand, the landowner uses the financial benefits for some short-term financial objective like operating expenses, he may again find him/herself needing money. However, this time the entire farm will likely have to be sold.

The landowner should consider various financial strategies in consultation with an attorney or accountant. For example, a farmer could take the proceeds from the sale of a conservation easement and reinvest it in another farm. If properly structured, such a transaction may qualify as a tax-free, like-kind exchange under Internal Revenue Code Section 1031. Obtaining sound legal and tax advice PRIOR to making such a decision is essential.

Expenses Associated with Easement Transactions

An appraisal, required to claim any tax benefit, is usually the most costly expense for the landowner. Since a conservation easement appraisal is really two appraisals in one (to determine the values before and after the easement) and requires special expertise, the fee can run into several thousand dollars. The landowner must also provide a title opinion and should have his/her own attorney draft the easement. If tax benefits form an important consideration, the landowner should consult an accountant. The Virginia Outdoors Foundation (VOF) manages a state fund to assist landowners with conservation easement expenses, with priority given to family farms and based on financial need.

Who Accepts Conservation Easements?

In Virginia, easements can be donated to a number of different public and private entities. The vast majority of conservation easements are donated to the VOF, a state agency established by the Virginia General Assembly to hold easements in public trust. In special cases, the Virginia Department of Historic Resources and the National Park Service may also accept easements. Additionally, easements can be held by qualified non-profit conservation organizations. While these organizations can legally accept and hold easements, we strongly urged landowners to donate their easements to VOF, as state-held easements offer a greater level of protection than easements held by private organizations.

To date, four counties and one city in Virginia have adopted and funded local purchase of development rights (PDR) programs: Albemarle, Clarke, Fauquier, and James City and the City of Virginia Beach. An additional five counties and one city have adopted but not funded PDR programs: City

of Chesapeake, Loudoun (discontinued), Rappahannock, Rockbridge, Spotsylvania, and Isle of Wight counties.

Conclusions

The possibilities for easement donation or sale are almost endless. Prime farmland may be appropriate for a conservation easement, but the tool should be used with caution. Part of the farm may be subject to the easement, or the entire farm. Terms of the easement are all negotiable.

Donation of a conservation easement involves complex considerations that require a thoughtful and deliberative process. The first step in determining whether to donate an easement is to discuss it with the family. If donation is agreed to among the family members, the landowner should consult an attorney, appraiser, financial advisor, and accountant to analyze options and discuss the ramifications of various courses of action. The action the landowner takes will irrevocably change the possibilities for the future use of the land.

Notices

****Please** notify the REAP office if your address changes or if you know of anyone who would like to be added to our mailing list.

****How to reach us:** REAP, Department of Agricultural and Applied Economics 0401, Virginia Tech, Blacksburg, VA 24061; by phone: (540) 231-9443; by email: reap01@vt.edu; or on the web at <http://www.reap.vt.edu/>

****Error correction:** The legend on the rural/urban map in the November/December 2006 *Horizons* was incorrect. The dark colored counties are urban while the white ones are rural. Our apologies for causing confusion.

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VT/001/01/07/3/4/271714



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